

Module K

Other Requirements Applicable to Certain Qualified Private Activity Bonds

Overview

Introduction

You will recall from IRC § 103(b) that in order for the interest on a private activity bond to be tax-exempt, the bond must:

- be a qualified private activity bond,
- not be an arbitrage bond, AND
- meet the requirements of IRC § 149.

In order to be a qualified private activity bond, IRC § 141(e) provides that a bond must:

- meet the requirements of IRC §§ 142, 143, 144, or 145, depending on the type of bond,
- meet the volume cap requirements of IRC § 146, AND
- meet the applicable requirements of IRC § 147.

Module K discusses the rules set forth in IRC § 147. These are general rules, which apply only to certain qualified private activity bonds. They do NOT apply to governmental bonds. Moreover, some of the rules do not apply to every type of qualified private activity bond. This module is divided into seven sections, as indicated below.

Failure to comply with these requirements precludes tax exemption for the interest on the bonds.

Continued on next page

Overview, Continued

Contents

This module contains the following topics:

| Topic | See Page |
|---|----------|
| Overview | K-1 |
| Section 1: Substantial User Requirement | K-4 |
| Section 2: Maturity Limitation | K-10 |
| Section 3: Limitations on Land Acquisition | K-16 |
| Section 4: Acquisition of Existing Property Not Permitted | K-19 |
| Section 5: Prohibited Facilities | K-22 |
| Section 6: Public Approval Requirement | K-23 |
| Section 7: Restriction on Issuance Costs | K-32 |
| Section 8: Remedial Actions | K-36 |
| Summary of Module K | K-37 |
| Class Exercises | K-39 |

Objectives

At the end of this module the student will be able to:

- Identify a substantial user.
 - Explain the effect that a substantial user can have on the tax-exempt status of any bonds purchased and held by him/her.
 - Determine if the maturity limitation has been met.
 - Explain the limitations on use of proceeds for land acquisition.
 - Explain the limitations on acquisitions of existing property.
 - Identify the facilities that cannot be funded with tax-exempt bonds.
 - Explain the public approval requirements.
- Explain the restrictions on use of proceeds for issuance costs.

Continued on next page

Overview, Continued

Legislative History

The Tax Reform Act of 1986 added section 147 to the Code. Prior to 1986, provisions parallel to those in IRC § 147 were found throughout section 103 of the 1954 Code, as shown below:

| Subject | 1986 Code | 1954 Code |
|--------------------------|-----------|------------|
| Substantial user | 147(a) | 103(b)(13) |
| Maturity limitations | 147(b) | 103(b)(14) |
| Land acquisition | 147(c) | 103(b)(16) |
| Existing property | 147(d) | 103(b)(17) |
| Skyboxes, airplanes, etc | 147(e) | 103(b)(18) |
| Public approval | 147(f) | 103(k) |
| Issuance costs | 147(g) | NA |
| Applicability | 147(h) | NA |

Section 1

Substantial User Requirement

Overview

Introduction IRC § 147(a) provides that interest paid on any qualified private activity bond is included in gross income of a substantial user (or a related person of a substantial user) for any period during which such obligation is held by a substantial user or related person. A violation of this requirement only jeopardizes the exempt status of interest income received by a substantial user of the bond-financed facility. The tax-exempt status of the bonds generally is not affected by a violation of section 147(a). The crux of this subsection is the identification of a “substantial user.”

In This Section This section contains the following topics:

| Topic | See Page |
|------------------|----------|
| Overview | K-4 |
| Substantial User | K-6 |
| Related Person | K-9 |

Continued on next page

Overview, Continued

Statutory Provisions

IRC § 147(a) provides the general rules regarding the substantial user requirement. Prior to the Tax Reform Act of 1986, these rules were in section 103(b)(13) of the 1954 Code.

Treas. Reg. § 1.103-11 provides rules applicable to the substantial user requirement.

Applicability

IRC § 147(h) provides that IRC § 147(a) does not apply to the following types of bonds:

- qualified mortgage bonds,
 - qualified veterans' mortgage bonds,
 - qualified student loan bonds, AND
 - qualified 501(c)(3) bonds.
-

Substantial User

General Definition

Treas. Reg. § 1.103-11(b) provides that a substantial user of a facility generally includes any nonexempt person who regularly uses a part of the facility in a trade or business. However, unless the facility was constructed, reconstructed, or acquired specifically for a nonexempt person, a nonexempt person will be a substantial user of a facility only if:

- the gross revenue derived by such user with respect to the facility is more than five percent of the total revenue derived by all users of the facility, OR
- the amount of area of the facility occupied by the user is more than five percent of the entire usable area of the facility.

Definition of a Nonexempt Person

Treas. Reg. § 1.103-7(b)(2) provides the definition of an “exempt person” as:

- a governmental unit, or
- a 501(c)(3) organization, but only with respect to its related activities.

Therefore a nonexempt person is any entity other than those identified above.

Example 1

In Rev. Rul. 76-406, 1976-2 CB 30, members of a tax-exempt farmers’ cooperative purchased industrial development bonds, issued as an exempt small issue by a political subdivision of a state, to finance the construction of a slaughter house and marketing facility to be leased to the cooperative for the benefit of its members. Even though none of the members derived more than five percent of the total revenue or occupied more than five percent of the usable space of the facility, the facility was constructed for and is operated for use in the members’ cattle business. Therefore, all of the members are treated as substantial users. Any interest the members receive on the bonds is included in their gross income.

Continued on next page

Substantial User, Continued

Example 2

In PLR 8003059, bonds were issued to finance the acquisition of land and construction thereon of a building to be used by a society as its headquarters. Members of the society were certified public accountants. The society planned to use the building for purposes that generally promoted the common interests of members. Although the society provided some services to its members, the building would not be used by any of the members as a site for providing services to their clients. The society offered the bonds for sale to its members. The members were not determined to be substantial users because they would not receive any significant commercial or economic benefit from the operation of the building in their trades or businesses as accountants.

Other Arrangements

Treas. Reg. § 1.103-11(b) provides that a nonexempt person may be a substantial user, if any of the following apply:

- has a contractual or preemptive right to the exclusive use of all or a portion of the property,
- is a lessee or sublessee of all or any portion of the facility, OR
- is a licensee whose use of the facility is regular and NOT merely casual, infrequent, or sporadic.

Individuals who are physically present on or in the facility as employees of a substantial user are usually NOT substantial users.

Example 3

Corporation X, a nonexempt person, borrows the entire principal amount of \$4M of County A's bonds. The bonds are qualified small issue bonds used to finance construction of a manufacturing facility, which will be leased to Corporation X for an annual rental of \$500,000. Corporation X subleases space to a restaurant operator at an annual rental of \$25,000. The restaurant is open five days a week from 8am until 5pm. The space physically occupied and the amount of revenue derived by the restaurant operator are more than five percent of the respective amounts with respect to the entire facility. Both Corporation X and the restaurant operator are substantial users of the facility. Corporation X is a substantial user because the facility was constructed specifically for its use. The restaurant operator is a substantial user because the space occupied and revenues earned by it exceed five percent of that of the entire facility. However, the employees of the restaurant as well as the manufacturers and distributors of the products sold at the restaurant are not substantial users. **(See Treas. Reg. § 1.103-11(c) Example 1.)**

Continued on next page

Substantial User, Continued

Example 4

City B proposes to issue \$2M of bonds which qualify as qualified small issue bonds, to construct a medical building for certain dentists and physicians. The facility will contain thirty offices to be leased on equal terms and for the same rental rates to each physician or dentist for use in his trade or business.

Each physician or dentist will be a substantial user of the facility since the facility is being constructed specifically for such physicians and dentists. The result would be the same if the office building were for general commercial use. **(See Treas. Reg. Section 1.103-11(c) Example 3.)**

Example 5

Authority E issues \$4M of bonds which qualify as qualified small issue bonds in order to construct a bank building on the grounds of an airport. The authority also issues \$40M to expand the airport. The bank will not derive revenue in excess of five percent of the revenue derived with respect to the airport nor will it occupy more than five percent of the usable area of such airport.

The bank will be a substantial user of the bank building because the facility was constructed specifically for the bank. However, the bank will NOT be a substantial user with respect to the airport because it does not exceed the five-percent limitations.

If Authority E had issued one issue of \$44M in order to expand the airport and construct a bank building, the bank would be a substantial user of the entire facility since the \$44M issue was being used to construct a facility a portion of which was specifically for the bank. **(See Treas. Reg. § 1.103-11(c) Example 6.)**

Related Person

Definition

IRC § 147(a)(2) provides that the following will be treated as related persons:

- two or more persons if the relationship between such persons would result in a disallowance of losses under IRC § 267 or 707(b),
 - two or more persons which are members of the same controlled group of corporations (as defined in IRC § 1563(a), except that “more than 50 percent” shall be substituted for “at least 80 percent” each place it appears therein),
 - a partnership and each of its partners (and their spouses and minor children), AND
 - an S corporation and each of its shareholders (and their spouses and minor children).
-

Section 2

Maturity Limitation

Overview

Introduction To prevent bonds from remaining outstanding longer than necessary, IRC § 147(b) limits the average length of maturity of certain qualified private activity bonds.

In This Section This section contains the following topics:

| Topic | See Page |
|---|----------|
| Overview | K-10 |
| Average Maturity of the Bonds | K-12 |
| Economic Life | K-13 |
| Special Rule for Pooled Financings of Qualified 501(c)(3) Bonds | K-15 |

Statutory Provisions IRC § 147(b) provides the general rules regarding the maturity limitation. Prior to the Tax Reform Act of 1986, these rules were in section 103(b)(14) of the 1954 Code.

Treas. Reg. § 1.147(b)-1 provides rules applicable to the maturity limitation.

General Rule IRC § 147(b) provides that interest paid on any qualified private activity bond is included in gross income if the average maturity of the bonds issued EXCEEDS 120 percent of the average reasonably expected economic life of the facilities being financed with the net proceeds of the issue.

Continued on next page

Overview, Continued

Applicability

IRC § 147(h) provides that IRC § 147(b) does NOT apply to the following types of bonds:

- qualified mortgage bonds,
- qualified veterans' mortgage bonds, AND
- qualified student loan bonds.

**Exception for
Working
Capital
Financings**

Treas. Reg. § 1.147(b)-1 provides that IRC § 147(b) does not apply to bond proceeds used to finance working capital expenditures. Treas. Reg. § 1.150-1(b) defines the term working capital expenditures as any cost that is not a capital expenditure and further states that current operating expenses are working capital expenditures. (Remember that only proceeds of qualified 501(c)(3) bonds can be used to finance working capital expenditures.)

Average Maturity of the Bonds

| | |
|--|--|
| Determination of Average Maturity | IRC § 147(b)(2)(A) provides that the average maturity of any issue shall be determined by taking into account the respective issue prices of the bonds issued as part of the entire issue. |
|--|--|

| | |
|--------------------|---|
| Computation | The following example illustrates the computation of the average maturity of bonds: |
|--------------------|---|

Example 6 City K issues \$5M principal amount of bonds, which are sold at par on January 1, 1998. The issue prices and maturity dates are shown below:

| Maturity Date | Issue Price |
|----------------------|--------------------|
| 1999 | \$1M |
| 2000 | \$1M |
| 2001 | \$1M |
| 2003 | \$2M |

There are three steps involved in the computation:

1. Multiply each issue price by the number of years remaining until maturity.
2. Add all of these products together.
3. Divide this sum by the principal amount of the bonds.

The computation below shows that the weighted average maturity of these bonds is 3.2 years.

| Issue Price | Number of Years Until Maturity | Product |
|------------------------------------|---------------------------------------|----------------|
| \$1M | 1 | 1M |
| \$1M | 2 | 2M |
| \$1M | 3 | 3M |
| \$2M | 5 | <u>10M</u> |
| | | |
| SUM OF PRODUCTS | | 16M |
| DIVIDED BY PRINCIPAL AMOUNT | | 16M/5M = 3.2 |

Economic Life

Determination of Average Reasonably Expected Economic Life

IRC § 147(b)(2)(B) provides that the average reasonably expected economic life of the facilities being financed with any issue shall be determined by taking into account the respective cost of such facilities.

Determination date

IRC § 147(b)(3)(A) provides that the reasonably expected economic life of any facility shall be determined as of the LATER OF:

- the date on which the bonds are issued, OR
 - the date on which the facility is placed in service (or expected to be placed in service.)
-

Determination of economic life

The House Conference Report No. 97-760, August 17, 1982 at pages 519 and 520 provides that the economic life of assets is determined on a case-by-case basis. However, the conferees intend that guidelines established for useful lives used for depreciation prior to the ACRS (the midpoint lives under the ADR system or guidelines provided by Rev. Proc. 87-56, 1987-2 CB 674 and Rev. Proc. 62-21, 1962-2 CB 418 in the case of structures) may be used. Further, the issuer can use longer lives when it can show that the economic life of the asset is actually longer than that established by the guidelines.

Rev. Proc. 87-56 is included at the end of this module as **Exhibit K-1**. Rev. Proc. 88-22, 1988-1 CB 785, which clarifies and modifies Rev. Proc. 87-56, is included as **Exhibit K-2**.

Treatment of land

IRC § 147(b)(3)(B) provides that land is not taken into account when computing the average economic life of a facility UNLESS 25 percent or more of the net proceeds of any issue is used to finance land.

When land is taken into account, it is treated as having an economic life of 30 years.

Continued on next page

Economic Life, Continued

Computation of average economic life The following example illustrates the computation of average economic life.

Example 7 Hospital System M borrows the proceeds of bonds issued by State B to build a parking garage. The building and its components along with their economic lives and respective costs are listed below:

| ASSET | ECONOMIC LIFE | COST |
|--------------------------------------|---------------|--------------------|
| Masonry multilevel parking structure | 25 | \$2,000,000 |
| Roof covering | 10 | \$50,000 |
| Electric lighting | 15 | \$10,000 |
| Passenger elevator | 20 | <u>\$5,000</u> |
| Total cost | | \$2,065,000 |

Computation of the average economic life is similar to that of the average maturity and involves three steps:

1. Multiply the economic life by the cost of the asset.
2. Add together all of these products.
3. Divide this sum by the total cost of the assets.

The computation shown below shows that the average economic life is 24.58 years. Therefore, the average maturity of the bonds cannot be more than 29.5 years (120 percent of 24.58 years.)

| Economic Life | Cost | Product |
|------------------------------|-------------|------------------------------------|
| 25 | \$2,000,000 | 50,000,000 |
| 10 | \$50,000 | 500,000 |
| 15 | \$10,000 | 150,000 |
| 20 | \$5,000 | <u>100,000</u> |
| SUM OF PRODUCTS | | 50,750,000 |
| DIVIDED BY TOTAL COST | | 50,750,000/2,065,000= 24.58 yrs |

Special Rule for Pooled Financings of Qualified 501(c)(3) Bonds

General Rule IRC § 147(b)(4) provides that for pooled issues where 95 percent or more of the net proceeds of the issue are used to make loans to 501(c)(3) organizations or governmental units for acquisition of property, **the issuer can elect** to satisfy general maturity limitation requirement by treating each loan as a separate issue.

Example 8 Charity Q and Charity R borrow proceeds from City A. The average economic life is computed for each charity's property separately. If Charity Q plans to acquire property having a 10-year ADR midpoint life, the maximum loan term permitted for Charity Q's loan is 12 years. If Charity R plans to acquire two properties, each with a different class life, then a weighted average economic life would be used as under the general 120 percent rule.

Requirements IRC § 147(b)(4)(B) provides that in order to make this election, the bonds must also meet the following requirements:

- 95 percent or more of the net proceeds of the issue must be used to finance loans to 2 or more 501(c)(3) organizations or governmental units for acquisition of property to be used by such organizations.
- the average maturity of each loan must not exceed 120 percent of the average reasonably expected economic life of the facilities financed by that loan,
- before the bonds are issued, a demand survey must be conducted which shows a demand for financing greater than an amount equal to 120 percent of the lendable proceeds of the issue,
- 95 percent or more of the net proceeds of the issue are to be loaned to 501(c)(3) organizations or governmental units within 1 year of issuance,
- any unspent proceeds after 1 year are to be used to redeem the bonds as soon as possible, but not later than 18 months after issuance, AND
- the maturity date of the bonds must not exceed 30 years.

Making the Election Treas. Reg. 301.9100-7T(g) provides that an election under IRC § 147(b)(4)(A) must be made in the bond indenture or a related document on or before the date of issue.

Section 3

Limitations on Land Acquisition

Overview

Statutory Provisions

IRC § 147(c) provides the general rules regarding limitations on use of proceeds for land acquisitions. Prior to the Tax Reform Act of 1986, these rules were in section 103(b)(16) of the 1954 Code.

There are no regulations applicable to this rule.

General Rule

IRC § 147(c) provides that a private activity bond will not be a qualified bond if:

- 25 percent or more of the NET PROCEEDS are to be used directly or indirectly for the acquisition of land or an interest in land, OR
 - any portion of the PROCEEDS is to be used directly or indirectly for the acquisition of land or an interest in land to be used for **farming purposes**.
-

Applicability

IRC § 147(h) provides that IRC § 147(c) does NOT apply to the following types of bonds:

- qualified mortgage bonds,
 - qualified veterans' mortgage bonds,
 - exempt facility bonds for qualified public educational facilities,
 - qualified student loan bonds, AND
 - qualified 501(c)(3) bonds.
-

Continued on next page

Overview, Continued

**Exception for
First-time
Farmers**

IRC § 147(c)(2) provides an exception to the general rule for land to be acquired by first-time farmers, if the requirements of IRC § 147(c)(2)(B) are met. A lifetime maximum of \$250,000 is available for this purpose. This limit does not include bond-financed land disposed of while the individual was insolvent.

“Farm” is defined under IRC § 6420(c)(2) as including stock, dairy, poultry, fruit, fur-bearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards.

First-time farmers may also use up to \$62,500 of the maximum \$250,000 to acquire used depreciable agricultural equipment under IRC § 147(c)(2)(F).

IRC § 147(c)(2) also includes relevant definitions and rules regarding acquisitions from related persons and aggregation, which apply to acquisitions by first-time farmers.

**Exception for
Land
Purchased for
Environmental
Purposes**

IRC § 147(c)(3) provides an exception to the general rule for any land acquired by a governmental unit (or issuing authority), if the land is acquired:

- in connection with:
 - an airport,
 - mass commuting facility,
 - high-speed intercity rail facility,
 - dock, or
 - wharf,
 - for noise abatement or wetland preservation, or for future use as any of the above facilities, AND
 - there is no other significant use of the land.
-

Continued on next page

Overview, Continued

**Relationship
With IRC
Section
147(b)(3)(B)**

Recall from the previous section that IRC § 147(b)(3)(B) provides that land is not taken into account when computing the average economic life of a facility UNLESS 25 percent or more of the net proceeds of any issue is used to finance land. Thus, this provision only applies in instances where the net proceeds of an issue are excluded from the general limitation under IRC § 147(c). Recall from earlier in this section that the general limitation rule of IRC 147(c) does NOT apply in the following instances:

- when the exception for first-time farmers applies,
 - when the exception for certain land acquired for environmental purposes applies, or
 - when the bonds are qualified mortgage bonds, qualified veterans' mortgage bonds, qualified student loan bonds, qualified 501(c)(3) bonds, or exempt facility bonds for qualified public educational facilities.
-

Section 4

Acquisitions of Existing Property

Overview

Statutory Provisions

IRC § 147(d) provides the general rules regarding the limitations on acquisitions of existing property. Prior to the Tax Reform Act of 1986, these rules were in section 103(b)(17) of the 1954 Code.

There are no regulations applicable to this rule.

General Rule

IRC § 147(d)(1) provides that a private activity bond will not be a qualified bond if any portion of the NET PROCEEDS is to be used for the acquisition of any property, or an interest in property, unless the first use of such property is pursuant to such acquisition.

Applicability

IRC § 147(d) does NOT apply to the following types of bonds:

- qualified mortgage bonds,
 - qualified veterans' mortgage bonds,
 - qualified student loan bonds, AND
 - qualified 501(c)(3) bonds.
-

More Than One Building

If a project involves two or more buildings, IRC § 147(d) is applied on a project, rather than on a building, basis.

Used Property vs Property With Used Parts

In PLR 8929073, used rails were incorporated into the construction of a new railroad line. The used rails, representing only 8.7 percent of the cost of the project, were an integral part of the entire railroad track structure, which is treated as a single piece of property with component parts for purposes of IRC § 38. Therefore, utilization of the used rail as a building material in the construction of the track structure would not constitute the utilization of separate property the first use of which did not begin with the taxpayer.

Continued on next page

Overview, Continued

Exception for Certain Rehabilitations

IRC § 147(d)(2) provides an exception to the general rule for:

- buildings (and equipment for the building), if rehabilitation expenditures equal or exceed **15 percent** of the cost of acquiring the building (and equipment for the building) financed with the net proceeds of the bonds, AND
 - structures other than buildings (i.e. dry docks), if rehabilitation expenditures equal or exceed **100 percent** of the cost of acquiring the structure financed with the net proceeds of the bonds.
-

Rehabilitation Expenditures

IRC § 147(d)(3) provides that rehabilitation expenditures are amounts:

- properly chargeable to capital account, AND
- incurred in connection with the rehabilitation of a building (including rehabilitating or replacing equipment existing in the building).

Any amount incurred by a successor to the purchaser or by the seller under a sales contract with the purchaser are treated as incurred by the purchaser.

Time Period

Qualifying rehabilitation expenditures must be made on or prior to the date which is two years after the later of:

- the date on which the building was acquired, OR
 - the date on which the bond was issued.
-

Qualified New York Liberty Bonds

IRC § 1400L(d)(5)(B) provides that IRC § 147(d) shall be applied to qualified New York Liberty Bonds by substituting “50 percent” for “15 percent” each place it appears.

IRC § 1400L(d)(2)(D) provides that qualified New York Liberty Bonds may only be issued prior to January 1, 2005 (the statute was enacted on March 9, 2002).

Continued on next page

Overview, Continued

Excluded Expenditures

For certain expenditures which are not “rehabilitation expenditures,” IRC § 147(d)(3)(B) refers to IRC § 47(c)(2)(B), after December 31, 1990. The following expenditures described in IRC § 47(c)(2)(B) are generally NOT rehabilitation expenditures:

- expenditures for which the straight line method over a proper recovery method is NOT used,
- the cost of acquiring the building or interest therein,
- expenditures for the enlargement of an existing building,
- certain expenditures for the rehabilitation of historic structures,
- expenditures for rehabilitation of a building allocable to tax-exempt use property (within the meaning of IRC § 168), AND
- certain expenditures of lessees.

(See Treas. Reg. §§ 1.48-12(c)(7) through (10) and 1.48-12(d) for rules regarding the above expenditures. Note that due to the redesignation of IRC §§ 48 to 47, effective December 31, 1990, the regulations accompanying current IRC § 47 are in Treas. Reg. § 1.48.)

In PLR 8831033, bond proceeds were used to acquire and rehabilitate a medical office building. Proposed improvements included construction of an elevated pedestrian walkway from the building to the garage to facilitate access for patients, including those with restricted mobility. Construction of the walkway was composed of two components: 1) minor demolition and interior modifications to create an entrance to the building; and 2) construction of the walkway from the exterior wall of the building to the garage. Any construction resulting in an increase in the volume of the building constitutes an enlargement under IRC § 48(g)(2)(B) even if such new construction only serves to facility access to the existing building and does not create additional leaseable space. Thus, expenditures for the walkway component would not be rehabilitation expenditures. However, since construction of the entrance component would not be part of an enlargement, such expenditures could be rehabilitation expenditures.

Exception for First-time Farmers

IRC § 147(c)(2)(A) provides that the first-time farmers exception (discussed in Module K, Section 3) to the limitation on use for land acquisition under IRC § 147(c) also applies to IRC § 147(d) for property to be used on a farm for farming purposes.

Section 5

Prohibited Facilities

Overview

Statutory Provisions

IRC § 147(e) provides the general rules regarding prohibited facilities. Prior to the Tax Reform Act of 1986, these rules were in section 103(b)(18) of the 1954 Code.

There are no regulations applicable to this rule.

General Rule

IRC § 147(e) provides that a private activity bond shall not be a qualified bond if any portion of the proceeds of the issue is used to provide any of the following:

- airplanes,
- skyboxes or other private luxury boxes,
- health club facilities
- facilities primarily used for gambling, OR
- stores the principal business of which is the sale of alcoholic beverages for consumption off premises.

Note that proceeds of qualified 501(c)(3) bonds are permitted to be used for health club facilities.

Principal Business of Alcohol Sales

In PLR 874300, a wholesaler leased a bond-financed warehouse and distribution facility for use in its business of buying alcoholic beverages from brewers and manufacturers for resale to retailers. Here, it was determined that IRC § 147(e) did not apply to a wholesale warehouse and distribution facility since only retail facilities sell alcoholic beverages for consumption.

In PLR 8646014, applying section 103(b)(18) of the 1954 Code, a wholesaler in the business of selling food and grocery items to restaurants and small grocers expanded its inventory to include alcoholic beverages. Here, it was concluded that the sale of alcoholic beverages for consumption off premises was not a principal business since the gross revenues and total inventory space allocated to such sales were less than 10 percent of the total operation.

Section 6

Public Approval Requirement

Overview

Introduction

IRC § 147(f) provides that a private activity bond shall not be a qualified bond unless such bond is part of an issue which has been approved by:

- the governmental unit which issued such bond or on behalf of which such bond was issued, AND
- each governmental unit having jurisdiction over the area in which the facility financed by the proceeds of such bond is located.

Public approval by a governmental unit can be either by:

- an “applicable elected representative” of such governmental unit after a **public hearing** following **reasonable public notice** about the bond issuance, OR
- voter referendum of such governmental unit.

This requirement is commonly known as the “TEFRA requirement” because it was originally added to the Code by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

In This Section This section contains the following topics:

| Topic | See Page |
|--|----------|
| Overview | K-23 |
| Obtaining Approval | K-25 |
| Reasonable Public Notice | K-27 |
| Other Rules | K-30 |
| Special Rules for Approval of Certain Qualified Private Activity Bonds | K-31 |

Continued on next page

Overview, Continued

Statutory Provisions

IRC § 147(f) provides the general rules regarding the public approval requirement. Prior to the Tax Reform Act of 1986, these rules were in section 103(k) of the 1954 Code.

Treas. Reg. § 5f.103-2 also contains rules which pertain to the TEFRA requirement.

Applicability

IRC § 147(f) applies to ALL qualified private activity bonds, without exception.

Obtaining Approval

Issuer Approval

IRC § 147(f)(2)(A)(i) and Treas. Reg. Section 5f.103-2(c)(2) provides generally that approval must always be provided by the government issuer or governmental unit on whose behalf the bonds will be issued.

If a governmental unit issues bonds on behalf of more than one governmental unit (i.e. a state authority issuing bonds on behalf of multiple counties), then any of such units may satisfy the issuer approval requirement.

Host Approval

IRC § 147(f)(2)(A)(ii) and Treas. Reg. § 5f.103-2(c)(3) provides that each governmental unit the geographic jurisdiction of which contains the facility to be financed by the issue must approve the issue. However, if the entire site of the bond-financed facility is within the geographic jurisdiction of more than one governmental unit within a State, then any one of such units may provide host approval for the issue with respect to that facility.

The issuer approval may be treated as satisfying the host approval requirement if the governmental unit giving the issuer approval meets both the issuer and host approval requirements.

Definition of Governmental Unit

Treas. Reg. § 5f.103-2(g)(1) provides that the term “governmental unit” has the same meaning as in IRC § 1.103-1 which provided that a governmental unit is a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof.

Example 9

State X proposes to issue private activity bonds to finance a facility located entirely within the geographic jurisdiction of City Y. Only State X must approve the issue because State X is the issuer and the facility is to be located entirely within the State’s geographic jurisdiction. If the State issued the bonds on behalf of the city, then only the city would need to approve them.

Example 10

County M proposes to issue private activity bonds to finance a project located partly within the geographic jurisdictions of both County M and County R. Both counties are located in State X. The part of the project in County R is located partly within the geographic jurisdictions of Cities O and P. Both issuer and host approval must be given by County M. Host approval must also be given by **either** State X, County R, or **both** Cities O and P.

Continued on next page

Obtaining Approval, Continued

**Definition of
Applicable
Elected
Representative**

IRC § 147(f)(2)(E) and Treas. Reg. Section 5F.103-2(e) provide that the term “applicable elected representative” means with respect to any governmental unit:

- its elected legislative body,
 - its chief elected executive officer,
 - if a State, its chief elected legal officer (e.g. Attorney General), OR
 - any other official elected by the voters of such unit and designated for purposes of this requirement by such unit’s chief elected executive officer or by State or local law to approve issues for the unit.
-

Example 11

In PLR 200126006, the governor of State Z left office mid-term, creating a vacancy. Per the State constitution, the president of the State senate, elected a senator by voters in a single district and voted president by a majority of the State senate, was sworn in as acting governor until an election to fill the office was held. The acting governor approved a proposed bond issue, to be issued by Authority Y on behalf of State Z, after a public hearing. Even though not elected at-large by the voters of State Z, the acting governor was treated as an applicable elected representative because the office was filled in accordance with State law and the acting governor was removable, with or without cause, by the State senate from the office of president.

If a governmental unit has no applicable elected representative, then approval shall be by the applicable elected representative of the next higher governmental unit:

- which has an applicable elected representative, AND
 - from which the authority of the governmental unit without one is derived.
-

Example 12

County M will issue bonds to finance a facility located in both County M and County R. Neither governmental unit has any officials who are elected at-large by the voters. Both units derive their authority from State X, the next higher governmental unit with an applicable elected representative. Thus, an applicable elected representative of State X must approve the issue for both Counties after the public notice and public hearing requirements are satisfied.

Reasonable Public Notice

What is “Reasonable Public Notice?”

Treas. Reg. § 5f.103-2(g)(3) provides that reasonable public notice means published notice which is reasonably designed to inform residents of the affected governmental units, including residents of the issuing unit and the unit where a facility is to be located, of the proposed issue.

The notice must state the time and place for the hearing and generally be published no fewer than 14 days before the hearing.

The notice is presumed reasonably designed to inform residents if:

- in the same manner and locations required by the governmental unit under state law for notice of public meetings,
 - published in one or more newspapers of general circulation, OR
 - announced by radio or television broadcast in the area.
-

Notice Must Contain Certain Information

Treas. Reg. § 5f.103-2(f)(2) provides that the notice of hearing and the approval must contain the following:

- a general, functional description of the type and use of the facility to be financed (e.g. 10,000 square foot machine shop and hardware manufacturing plant, 400-room airport hotel building, dock facility for supertankers, convention center auditorium and sports arena with 25,000 seating capacity, air and water pollution control facilities for oil refinery),
 - the maximum aggregate face amount of obligations to be issued with respect to the facility,
 - the initial owner, operator, or manager of the facility, AND
 - the prospective location of the facility by its street address or, if none, by a general description designed to inform readers of its specific location.
-

Continued on next page

Reasonable Public Notice, Continued

Inadequate Notice

Treas. Reg. § 5f.103-2(f)(2) provides that an approval will not be rendered invalid due to an **insubstantial deviation** from the information required in a notice. However, an approval or notice of hearing will not be considered adequate if any of the required information is unknown on the date of the approval or the date of the public notice.

Example 13

In PLR 9622032, a state agency proposes to issue pool bonds and lend the proceeds to 501(c)(3) organizations. The specific organizations receiving the proceeds will not be known until after the issuance date. It intends to elect to qualify for the special maturity rule for pooled financings under section 147(b)(4). The agency will publish a public hearing notice containing a general, functional description of the type of facilities to be financed and the maximum aggregate amount of the obligations used to finance the facilities. Here, the notice was determined to be inadequate because it would not identify the initial owner, operator, or manager of the proposed facilities or the facilities' prospective locations.

Example 14

In PLR 9508029, Authority W issued qualified 501(c)(3) bonds and loaned the proceeds to Hospital B to finance the construction and renovation of capital facilities at the hospital as well as the acquisition of capital equipment. A notice of public hearing for the bonds described the project, listed its location, identified Hospital B as the initial owner, and provided the aggregate face amount of the bonds. Although many of the specific items included within the project had been completed, approximately 25 percent of the bond proceeds remained unspent prior to Hospital B's merger with Hospital A. Thereafter, management decided to use the remaining bond proceeds to finance capital renovations and capital equipment at Hospital A which was located approximately 1 mile away from Hospital B. Here, the deviation was determined to be insubstantial because the proceeds were to be used in a nearby facility in the same manner as originally approved and that the deviation would not impact the residents in the locality of the facilities.

PLRs 200049022 and 200050026 both reach the same result based upon similar facts where the alternate facility was approximately one-half mile away from the facility originally identified in the public hearing notice.

Continued on next page

Reasonable Public Notice, Continued

Example 15 In PLR 9452021, Authority G issued qualified 501(c)(3) bonds and loaned the proceeds to Hospital Q to finance capital improvements to its facility. A notice of public hearing described the project, listed its location, identified Hospital Q as the initial owner, and provided the aggregate face amount of the bonds. Due to subsequent financial distress, Hospital Q proposed to expend a portion of the unspent proceeds on working capital and other ongoing operating expenses related to the facility. Here, the deviation was determined to be insubstantial because only a very small percentage of the gross proceeds were to be used for alternate purposes.

Public Hearing Treas. Reg. § 5f.103-2(g)(2) provides generally that a public hearing means a forum providing a reasonable opportunity for interested individuals to express their views, both orally and in writing, on the proposed issue of bonds and the location and nature of a proposed facility to be financed.

Other Rules

Time Frame

IRC § 147(f)(2)(C) provides that once public approval has been obtained for a plan of financing a facility, that approval shall constitute approval for any issue:

- which is issued pursuant to such plan within 3 years after the date of the first issue pursuant to the approval, AND
- all or substantially all of the proceeds of which are to be used to finance such facility or to refund previous financing under the plan.

Treas. Reg. 5f.103-2(g)(3) also provides that the first issue of the plan of financing satisfying the approval requirement must have been issued no later than 1 year after the date of approval.

Refunding Bonds

No approval is necessary for current refunding bonds as long as:

- the original bond met the public approval requirements, and
- the average maturity date of the refunding issue is NOT later than that of the refunded bonds.

The public approval requirements of IRC § 147(f) must be met by advance refundings.

Special Rules for Approval of Certain Qualified Private Activity Bonds

Airports and High-Speed Intercity Rail Facilities

For the purposes of the public approval requirement, IRC § 147(f)(3) provides that a governmental unit will be considered to be the only governmental unit having jurisdiction over an airport or high-speed intercity rail facility if:

- the proceeds of the bonds are to be used to finance a facility located at an airport or high-speed intercity rail facility, AND
 - the governmental unit issuing the bonds is the owner or operator of the facility.
-

Scholarship Funding Bonds

IRC § 147(f)(4)(A) provides that for purposes of the public approval requirement, any governmental unit which made a request described in IRC § 150(d)(2)(B) with respect to the issuer of such bond shall be treated as the governmental unit on behalf of which the bond was issued.

When more than one governmental unit within a State has made such a request, the State may also be treated as the governmental unit on behalf of which such bond was issued.

Volunteer Fire Department Bonds

IRC § 147(f)(4)(B) provides that with respect to any volunteer fire department which meets the requirements of IRC § 150(e), the political subdivision described in IRC § 150(e)(2)(B) will be considered the governmental unit on behalf of which the bond was issued for purposes of the public approval requirement.

Section 7

Restriction on Issuance Costs

Overview

Contents

This section contains the following topics:

| Topic | See Page |
|-----------------------------------|----------|
| Overview | K-32 |
| Introduction | K-34 |
| Calculating the Two Percent Limit | K-35 |

Statutory Provisions

IRC § 147(g) provides the rules regarding costs of issuance. These rules were added to the Code by the Tax Reform Act of 1986.

There are no regulations applicable to these rules.

General Rule

IRC § 147(g)(1) provides that a private activity bond shall not be a qualified bond if the issuance costs financed by the issue exceed 2 percent of the **proceeds** (NOT face amount) of the issue.

Applicability

IRC § 147(g) applies to all types of qualified private activity bonds.

Under Treas. Reg. § 1.141-3(g)(6), issuance costs are treated as neutral costs when applying the private business tests under IRC § 141(b) to governmental bonds.

Relationship with “95 percent” Test

As was discussed in prior modules, at least 95 percent of the net proceeds of qualified private activity bonds must be used for the qualified purposes of the issue. Amounts used to finance any costs of issuance are NOT treated as spent for the qualified purpose of the issue. Thus, the amount of proceeds allocated to issuance costs must also be allocated to the 5 percent permissible “bad use” portion of the net proceeds.

Continued on next page

Overview, Continued

Example 16

County E issues \$1,000,000 bonds and loans the money to Corporation F, which will own and operate a solid waste disposal facility. Use of proceeds is shown below:

| | |
|--------------------|---|
| \$1,000,000 | Sale and investment proceeds |
| < <u>100,000</u> > | Deposit to 4R Fund |
| 900,000 | Net Proceeds |
| <u>x .95</u> | |
| 855,000 | Min. amount required to be allocated to qualified purposes |
| 900,000 | |
| <u>x .05</u> | |
| 45,000 | Max. amount allowed for nonqualified purposes |
| < <u>20,000</u> > | Max. amount allowed for issuance costs |
| 25,000 | Amount of proceeds available for nonqualified purposes other than issuance costs. |

Introduction

What are Issuance Costs?

Treas. Reg. § 1.150-1(b) includes the following costs as issuance costs:

- underwriter's discount,
 - counsel fees,
 - financial advisory fees,
 - rating agency fees,
 - trustee fees,
 - paying agent fees,
 - bond registrar, certification, and authentication fees,
 - accounting fees,
 - printing costs for bonds and offering documents,
 - public approval process costs,
 - engineering and feasibility study costs, AND
 - guarantee fees, other than for qualified guarantees.
-

Special Rule for Small Mortgage Revenue Bonds

IRC § 147(g)(2) provides that in the case of qualified mortgage bonds or qualified veterans' mortgage bonds, the issuance cost limitation is increased to 3.5 percent if the bond proceeds do not exceed \$20 million.

Qualified 501(c)(3) Bonds

Qualified 501(c)(3) bonds must satisfy the requirements under IRC § 147(g) even though they are permitted to allocate bond proceeds to finance working capital expenditures. Recall from Module I that, under IRC § 145(a)(2)(B), qualified 501(c)(3) bonds must satisfy the private business tests of IRC § 141(b) by treating 501(c)(3) organizations as governmental units and substituting "5 percent" for "10 percent" each place it appears and "net proceeds" for "proceeds" each place it appears.

In applying these tests to qualified 501(c)(3) bonds, Treas. Reg. § 1.145-2(c)(2) provides that issuance costs are to be treated as private business use. This differs from the general rule for governmental bonds under Treas. Reg. § 1.141-3(g)(6) which provides for the ratable allocation of issuance costs, as neutral costs, among the purposes for which the bonds were issued.

Additional Issuance Costs

Treas. Reg. § 147(g) does not prohibit an issuer from incurring issuance costs in excess of the 2 percent limitation. An issuer can always use other funds to pay for these excess issuance costs.

Calculating the Two Percent Limit

Example 17

County H issues \$12M principal amount of bonds on June 1, 1997, and loans the proceeds to Developer A to build a sewage facility. The bonds are sold at a premium, allowing County H to receive \$12.5M in sale proceeds. Assume there were no investment proceeds. The county incurred the following expenses in connection with the bond issuance:

- underwriter's discount \$120,000
- counsel fees 75,000
- trustee fees 20,000
- bond insurance premium 24,000

The 2% limit is calculated as follows:

| | |
|---|----------------------|
| Proceeds | \$12,500,000 |
| Deposit to 4R Fund | < <u>1,250,000</u> > |
| Net Proceeds | 11,250,000 |
| | <u> x .95</u> |
| Min. amount to be allocated to project | 10,687,500 |
| | |
| Net Proceeds | \$11,250,000 |
| | <u> x .05</u> |
| Max. amount allowed for bad use | 562,500 |
| Max. amount allowed for issuance costs | < <u>250,000</u> > |
| Amount available for nonqualified purposes other than issuance costs | 312,500 |

If County H uses more than \$250,000 of the bond proceeds to pay issuance costs, the bonds violate IRC § 147(g) and cannot be qualified private activity bonds. The underwriter's discount, counsel fees, and trustee fees all qualify as issuance costs paid by County H. The bond insurance premium is a qualified guarantee under Treas. Reg. § 1.148-4(f) and, as such, is properly treated as an interest expense and excluded from the 2 percent limitation on issuance costs. Accordingly, the total amount of proceeds allocated to issuance costs by County H is equal to \$215,000 (1.7 percent of the proceeds), satisfying Treas. Reg. § 147(g).

Moreover, since the \$215,000 in issuance costs is considered private business use, it is allocated to the \$562,500 allowed for nonqualified purposes leaving only \$347,500 (or 3.1 percent of net proceeds) available for other nonqualified expenditures.

Section 8

Remedial Actions

Overview

| | |
|-----------------------------|---|
| Statutory Provisions | Treas. Reg. § 1.147-2 provides remedial actions to correct certain violations of the requirements of IRC § 147. |
|-----------------------------|---|

| | |
|---------------------|--|
| General Rule | <p>Treas. Reg. § 1.147-2 provides that the remedial action rules of Treas. Reg. § 1.142-2 (available to exempt facility bonds) apply to the rules in IRC § 147 for qualified private activity bonds that:</p> <ul style="list-style-type: none">• permit use of proceeds to acquire land for environmental purposes (see IRC § 147(c)),• permit use of proceeds to finance certain rehabilitations (see IRC § 147(d)(2) and (3)),• prohibit use of proceeds to finance skyboxes, airplanes, gambling establishments and similar facilities (see IRC § 147(e)), AND• require public approval (see IRC § 147(f)). |
|---------------------|--|

| | |
|-----------------------------|--|
| Application of Rules | For purposes of applying the remedial action rules under Treas. Reg. § 1.142-2 to the instances described above, the qualified private activity bonds subject to the rules of IRC § 147 are to be treated as exempt facility bonds and the qualifying purposes for those bonds as exempt facilities. |
|-----------------------------|--|

Summary of Module K

Review of Module K

Module K discussed the requirements of section 147 that must be met in order for a private activity bond to be a **qualified** private activity bond. IRC § 141(e), which defines qualified private activity bonds, explicitly provides that these requirements, as well as those of section 146, be satisfied. Qualified private activity bonds must also comply with all the requirements generally applicable to tax-exempt bonds.

Generally, the provisions of IRC § 147 as they apply to certain qualified private activity bonds are as follows:

- Section 147(a) prohibits a substantial user of a facility, who holds the bonds financing that facility, from receiving tax-exempt interest paid thereon.
- Section 147(b) limits the length of maturity of bonds to 120 percent of the economic life of the bond-financed facility.
- Section 147(c) limits the amount of net proceeds of bonds that can be used for the acquisition of land.
- Section 147(d) generally prohibits any portion of the net proceeds of the bonds from being used to acquire existing property.
- Section 147(e) lists certain purposes that may NOT be financed with qualified private activity bonds.
- Section 147(f) requires that there be public approval of all qualified private activity bonds.
- Section 147(g) limits the amount of proceeds that may be used to pay for issuance costs.

Figure K-1 shows the section 147 requirements and their applicability to specific types of qualified private activity bonds.

Preview of Module L

Although the provisions of IRC § 147 generally do not apply to governmental bonds, they can become relevant when a “change in use” occurs.

A change in use occurs when an event takes place subsequent to the issuance date that causes the bond-financed facility to be used for a purpose other than the qualified purpose for which the bonds were issued.

Continued on next page

Summary of Module K, Continued

Figure K-1 Applicability of IRC Section 147 Provisions

| Type of qualified private activity bond | Substantial User | Maturity Limitation | Land Acquisition and Existing Property Limitations | Prohibited Facilities | Public Approval | Issuance Costs Restrictions |
|--|-------------------------|----------------------------|---|------------------------------|------------------------|------------------------------------|
| Exempt Facility Bonds | Applies | Applies | Applies, but see Note 1 | Applies | Applies | Applies |
| Mortgage Bonds | N/A | N/A | N/A | Applies | Applies | Applies, but see Note 3 |
| Veterans' Mortgage Bonds | N/A | N/A | N/A | Applies | Applies | Applies, but see Note 3 |
| Small Issue Bonds | Applies | Applies | Applies | Applies | Applies | Applies |
| Student Loan Bonds | N/A | N/A | N/A | Applies | Applies | Applies |
| Redevelopment Bonds | Applies | Applies | Applies | Applies | Applies | Applies |
| 501(c)(3) Bonds | N/A | Applies | N/A | Applies, but see Note 2 | Applies | Applies, but see Note 4 |

Note 1: IRC § 147(c) does not apply to qualified public educational facilities.

Note 2: Qualified 501(c)(3) bonds may be used for healthclubs.

Note 3: Issuance cost limit equals 3.5 percent if proceeds do not exceed \$20 million.

Note 4: Treas. Reg. § 1.141-3(g)(6) is NOT applicable despite requirement that IRC section 141 be applied.

Class Exercises

Exercise 1

To finance the construction of an exempt facility, City C plans to issue short-term bond anticipation notes (BANS) in the amount of \$89M. Nonexempt Corporation X, who will be the owner of the facilities, will purchase the BANS. All of the note proceeds will be used to pay the costs of constructing exempt facilities, as described under IRC § 142(a). After construction is completed, City C will issue long-term bonds in the amount of \$100M, of which, \$89M will be used to retire the notes and \$11M will be used to pay the accrued interest on the notes.

Question: Is the interest on the BANS tax-exempt?

Why or why not?

Exercise 2

Authority B issued bonds in April 1990 to finance expansion and remodeling projects at Hospital G. In connection with the bond issuance, Authority B published a notice of public hearing for the bonds that stated the proceeds were to be used for the acquisition, construction, equipping, and renovation of certain Hospital G's health facilities, and for refinancing of certain outstanding indebtedness of Hospital G. Project facilities were described as located on Site A, Site B, Site C, Site D, and Site E. After completion of the project, Hospital G had bond proceeds left over (amounting to 3.2% of total bond proceeds) which it wished to use to construct a new medical clinic replacing the existing facility at Site F. None of the sites are geographically contiguous, but all are part of an integrated medical health care system.

Question: Is the use of bond proceeds for the new clinic at Site F an insubstantial deviation from the public notice requirements?

Why or why not?

Continued on next page

Class Exercises, Continued

Exercise 3 You are reviewing a “Use of Proceeds” schedule from the costs of issuance fund. The conduit borrower has spent nearly 2 percent on the costs of issuance.

Question: What else should you look at?

Question: What is not necessary to look at?
